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DEBT, STABILIZATION, AND LIBERALIZATION IN COSTA RICA: POLITICAL ECONOMY RESPONSES TO A FISCAL CRISIS.

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DEBT, STABILIZATION, AND LIBERALIZATION IN COSTA RICA: POLITICAL ECONOMY RESPONSES TO A FISCAL CRISIS.

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Recent papers by both macroeconomists and new political economy theorists --such as Corden (1987), Lal (1987), and Srinivasan (1985)-- have begun to examine the impact of interest groups within an economy on the generation of fiscal and balance-of-payments crises and on the success of stabilization-cum-liberalization efforts. Drawing on the Chilean experience, Edwards and Edwards (1987) have stressed that the explicit consideration of the behavior of decisive actors in the polity is critical for the choice of the timing, sequencing, and speed of implementation of policy reforms, if counter-productive behavior or the reversal of the policy orientation is to be avoided. As Calvo (1987) has shown, if liberalization efforts are perceived as temporary, they induce economic behavior that actually reduces the level of welfare. Nelson (1984) also makes the point that the importance of considering political sustainability arises not only from the substantial welfare costs of failed programs but also because failure creates a legacy of cynicism that may seriously complicate future liberalization efforts.

Since second-best considerations arise when the existence of political and administrative constraints to the implementation of optimal policies is recognized, it is not surprising that few clear-cut guidelines for the construction of policy packages are possible. The analysis of specific episodes may then contribute to a better understanding of the ways in which political economy developments may influence the outcomes of policy decisions. This chapter is an attempt to provide an analytical political-economy history of the recent fiscal crisis in Costa Rica, an episode rich in lessons for similarly small open economies.

I. Political Economy Background

Among Latin American countries Costa Rica has been unique in terms of its political stability and the strength of its democratic institutions. Sustained political stability has promoted economic growth: it has favored investment, it has attracted foreign savings, and it has reduced the risks and transactions costs of economic activity by promoting an institutional infrastructure that has efficiently defined property rights and facilitated the enforcement of contracts. The absence of an army has released resources for education, health, and physical infrastructure. The emphasis on equity has reinforced human capital formation. As a result Costa Rica has enjoyed rapid economic growth, while its major indicators have reflected a higher quality of life than would be predicted for its per capita income level. Income inequality has been moderate and Costa Rica has been an example of growth-cum-equity, as documented by González-Vega and Céspedes (1987).

Political stability and democratic participation have also contributed, on the other hand, to the consolidation of a multitude of interest groups, to overconsumption, and to an increasingly rigid deadlock of power shares, in a manner consistent with the analysis of Olson (1982). Education and social mobility have fueled rising expectations and growing demands for public-sector services. Combined with a strong concern for equity, these demands have led to the institutionalization of numerous growth-reducing fiscal entitlements and transfer payments.

Promotion of manufacturing in the context of the Central American Common Market, for example, had initially accelerated growth in the 1960s as a result of increased trade. By the 1970s, however, the easy stages of import substitution had been exhausted, new exports had been discouraged, distortions had slowed down the growth of productivity, and increasingly powerful interest groups devoted scarce resources to directly unproductive activities of the sort described by Bhagwati (1982). The accumulation of entitlements added to the existing distortions, enlarged the public sector, and promoted bureaucratic controls and regulations. The decentralized agencies and state-owned firms became pressure groups in their own right and claimed substantial shares of the available resources.

Under the Oduber administration (1974-1978), CODESA, the public investment corporation, became an instrument for the state's intervention in productive activities in direct competition with the private sector. CODESA's non-restricted access to Central Bank credit became a major component of the deterioration of the public-sector finances. While CODESA's enterprises used 18 percent of domestic credit, they contributed only 1.8 percent of gross domestic product and 0.3 percent of total employment. Between 1976 and 1983 none of CODESA's subsidiaries ever made a profit, while the accumulated losses (CR$ 2.059 million) represented 35 percent of all of their assets, as documented by Vargas (1987).

Because CODESA was not restricted by the political controls typical of government agencies or by the profit discipline of private firms, the agency became a factory of quasi-rents. The larger the project, irrespective of profitability, the greater its political visibility and the larger the rents created. Nevertheless, Vega (1982) shows that competition with the private sector created tensions in the symbiotic relationship that had developed between the state and the industrialists. By the end of the Oduber administration, an important group of manufacturing leaders left Oduber's political party and supported the election of Carazo (1978-1982), who would preside over the eruption of the economic crisis of the 1980s.

II. Determinants and Magnitude of the Crisis

During the 1980s Costa Rica has experienced a major economic crisis, the result of a combination of unfavorable long-term trends and short-term circumstances, both foreign and domestic. The structural determinants of the crisis have reflected a contradiction between the country's basic characteristics (a small domestic market, relative labor abundance, and very specialized natural resources) and features of the protectionist strategy of industrialization adopted in the late 1950s. High costs and distortions resulted from the penalization of agriculture and the anti-export bias of trade policies. The short-term determinants of the crisis have included, on the other hand, major external shocks as well as the unfortunate domestic policies adopted in response to those shocks, described in detail in González-Vega (1984).

The Costa Rican economy grew at a very satisfactory pace during the 1960s and 1970s. Between 1961 and 1979 the rates of growth of the real GDP and per capita GDP were 6.5 and 3.4 percent per year. Moreover, Costa Rica did not experience inflation before the mid-1970s. For 1950-1970 average rates of change were 1.0 percent for the wholesale price index, 1.8 percent for the GDP deflator, and 2.0 percent for the consumer price index. During the first oil shock the wholesale price index increased 40 percent in 1974, but inflation was quickly brought under control. Fiscal and credit discipline sustained a fixed exchange rate regime for a long period.

In sharp contrast, during the 1980s Costa Rica has experienced major economic difficulties. An economy that for over two decades had enjoyed rapid growth faced declining output and trade flows. The rate of growth of GDP dropped from 8.9 percent in 1977 to - 7.3 percent in 1982. The decline of growth rates was shared by all sectors of economic activity and by all components of aggregate supply and demand. By 1982 fixed investment amounted to 49 percent of its 1979 level while imports represented 58 percent of that earlier level. Both exports and imports declined and the country's trade deficit, which had grown from US$ 92 million in 1972 to US$ 522 million in 1980, had to be curtailed to US$ 23 million by 1982.

Before the 1980s Costa Rica had been successful in generating employment opportunities and in using its labor markets to distribute the fruits of growth. According to García and Tockman (1985) Costa Rica had been the country in Latin America with the highest rate of growth of employment in modern, non-agricultural activities. Factor-price policies, however, had discouraged employment in the private sector and the public sector had increasingly become the employer of last resort. Public-sector employment increased from 6 percent of the labor force in the early

1950s to 20 percent in the early 1980s. The large size of some ministries (e.g., Education) and of several autonomous institutions had facilitated the creation of strong middle-class labor unions. While almost one-half of the public-sector workers were unionized by the late 1970s, the proportion was 10 percent for the total labor force. These unions had negotiated public-sector wages well above those for equivalent occupations in the private sector.

With the crisis open unemployment rates at least doubled, from 4.5 percent of the labor force in 1979 to 9.5 percent in 1982, while underemployment increased substantially. From one-digit rates in the late 1970s, inflation accelerated in the 1980s. In 1981 the wholesale price index increased 65 percent and it rose another 108 percent in 1982. Once fiscal control was regained, the rate of inflation declined to 8 percent in 1984. As a consequence of a declining level of output in the face of high inflation, by 1982 average real wages had dropped to 46 percent of their 1979 level. They still were at about two-thirds of that level by the end of 1984.

III. External Shocks and Policy Management

After 1973 Costa Rica experienced several major external shocks: two international oil crises, the coffee boom, a world recession, sharp changes in the country's degree of access to international financial markets, the breakdown of trade with the Central American Common Market, and war, insurrection, political instability, and capital flight in Central America. The structural rigidities that had resulted from the protectionist strategy of development had created, in the meantime, an economic environment less conducive to quick and smooth adjustment to external shocks. In addition, unfortunate policy choices in response to the political economy pressures magnified the negative impacts of these shocks. As a result the country experienced both substantial instability and a major impoverishment.

The 1974 oil crisis had imposed the first major challenge of adjustment of recent times. It had been faced by the authorities with a rapid expansion of both domestic and foreign credit in order to prevent the reduction of aggregate expenditures. The deterioration of the international terms of trade, due to the higher import prices, was followed by an improvement of 45 percent in only two years (as the index rose from 79 in 1975 to 115 in 1977), with the accompanying increase in real income during the coffee boom, and then by a 22 percent decline in three years (from 101 in 1978 to 79 in 1981). This wide fluctuation in relative prices and in real income imposed a drastic problem of adjustment on the economy.

Rapidly growing foreign borrowing on top of the extraordinary expansion of export earnings during the coffee boom created new opportunities for the capture of quasi-rents and substantially increased all categories of aggregate spending. Consumption augmented rapidly, public-sector activities grew even more, and imports increased the most, reaching almost one-half of the aggregate supply. All expenditure aggregates grew beyond levels that could be sustained under normal circumstances, much less during the recession that followed.

The obviously transitory increase in income during the coffee boom was treated as if it had resulted in a new, higher level of permanent income. This perception was strengthened by the relative success of the Costa Rican experiment and was celebrated with a spending euphoria. The government --already an interventionist, welfare state-- became a major entrepreneur via the activities of CODESA and gave little attention to the modification of tax structures or the mobilization of domestic savings through the financial system. The Oduber administration used the extraordinary resources of the coffee boom, augmented by substantial borrowing abroad, to increase the size and role of the state and to strengthen the popularity of the president. Just before the end of the Oduber administration very short-term borrowing was undertaken in order to pile up over U.S. $300 million of international monetary reserves. These loans had to be paid back a few months after the new Carazo administration took office.

While the end of the coffee boom, the deterioration of the country's international terms of trade, and the world recession required a major adjustment of the Costa Rican economy, the government found it difficult to bring the rate of growth of aggregate expenditures downwards to a level consistent with the new circumstances. Import capacity was curtailed by the reduction in export earnings and in private capital inflows due to political instability in Central America, but the required austerity encountered much political opposition.

The powerful manufacturing sector had become extremely dependent on imported inputs as a consequence of the prevailing structure of effective protection and was prepared to defend its entitlements. The strong public-sector unions, on the other hand, were ready to block any attempt at fiscal control. Numerous organized groups struggled to maintain their standard of living, aided by the government's expansionary credit policies.

Based on a weak coalition, the Carazo administration did not oppose the efforts of the more powerful interest groups to avoid the direct impact of the adjustment. Rather, the authorities chose to postpone the adjustment by borrowing heavily from abroad. Costa Rica's public external debt, which had amounted to U.S. $164 million in 1970 increased to US$ 3,419 by 1984, at an annual rate of 24 percent, to become one of the highest external debts in the world, in per capita terms. The motto of the Carazo administration was "ride the wave of foreign debt to the maximum."

The stock of accumulated fiscal deficits financed abroad, however, eventually reached the limit that foreign lenders were willing to accept. When capital inflows began to dry up, the authorities expanded domestic credit even more rapidly in order to sustain the level of spending of the public sector. Eventually a moratorium on the debt service became an additional mechanism for not fully facing the consequences of the fiscal disequilibrium. The resulting inflationary pressures led to the loss of the stock of international monetary reserves and to additional borrowing abroad in order to replenish those reserves. Once those reserves were exhausted and access to foreign funds ceased, domestic inflation accelerated. When the revenues from the inflation tax declined, as a result of currency substitution and other mechanisms of evasion, the private sector was crowded out from domestic credit portfolios. The proportion of domestic credit for the private sector declined from 81 percent in 1975 to 55 percent. This crowding out accentuated the decline in output, as reported by Blejer and Khan (1985) for similar situations.

The accompanying financial repression led to a significant contraction of the domestic financial system in real terms, as documented in detail in González-Vega (1985). In constant prices, by 1982 the narrow money supply (M1) dropped to 56 percent of its 1978 value, while a broader measure of the money supply (M2) declined to 69 percent of its 1978 value. Moreover, by 1982 total domestic credit was 42 percent of its 1980 value while credit for the private sector reached only 36 percent of its 1978 level. Domestic credit for the public sector continued to increase through 1980, but then it also declined. By 1982 domestic credit to the public sector reached only 46 percent of its 1980 level. In the race between inflation and the expansion of credit for the public sector, the former was the easy winner.

As a result of the government's inability to undertake appropriate measures to reduce the fiscal deficits and of the fear to the political costs of an outright devaluation, exchange-rate management became chaotic. In 1980 the free-market rate of the parallel market at the Stock Exchange had begun to diverge from the fixed official rate. By September the authorities moved to an institutionalized multiple-rate system. By December a floating-rate regime was adopted. By March 1981 a banking rate, to be administered by the Central Bank, was introduced in addition to the free-market and official rates. The official devaluation did not come until December. The new rate was set, however, at less than one-half of the prevailing free-market rate. In July 1982 the parallel market was prohibited and the new authorities began a process of convergence of the banking and official exchange rates. A crawling-peg system was adopted once convergence was achieved. With the collapse of the fixed-rate regime, the exchange rate had increased from CR $8.60 per U.S. dollar in early 1981 to CR $62.40 in mid-1982. It was unified at CR $42.50 by the end of 1983 and it reached CR$ 58.60 by the end of 1986.

Experimentation with all kinds of exchange-rate practices, taxes and subsidies, import and exchange controls, prior deposits, and other policy instruments reflected the weakness of the authorities and the strength of the interest groups. This situation led to frequent changes in the rules of the game, increasing uncertainty, and the creation of hybrid systems that lacked any internal logic. Numerous policy reversals, exceptions, and privileges were continuously added in response to the political pressures from rent-seeking groups. Eventually few people understood the system, while major distortions in resource allocation and inequities in wealth distribution resulted. A large bureaucracy had to be hired at the Central Bank in order to administer the system, while numerous legal battles were the consequence of the complexity and prevailing confusion about the correct interpretation of contradictory regulations. Arbitrariness and complexity significantly increased uncertainty and the social costs of the measures.

IV. Political Economy of the Crisis

The Costa Rican balance-of-payments crisis has essentially been a crisis for the public sector and it has reflected a misjudgment about its appropriate and feasible size and composition. The increased level of government expenditures and income transfers that resulted from the coffee boom was not sustainable over the long run. While there is a possibility that the authorities simply misjudged the size of the future foreign-exchange flows and committed themselves to unsustainable consumption-support programs, the bulk of the overexpansion may be attributed to the political economy pressures.

Political stability and democratic participation had promoted the creation of entitlements to current and future income streams for a multitude of interest groups (industrialists, public-sector workers, social-security beneficiaries, small-farmer borrowers, rice growers, and cattle ranchers). Given the legal formality of the Costa Rican system, such entitlements had been institutionalized as specific "property rights." This institutionalization, in the form of revenue earmarking and legal spending requirements, had in turn reduced the discretionary powers of the authorities and had limited their flexibility to adjust to changes in the economic environment. In order to meet growing demands for services and transfers, new sources of revenues had to be sought to support an ever increasing public sector. In addition, the predominant position of the nationalized banks in the financial system made it possible to direct domestic credit to the financing of public-sector activities and income transfers.

With the coffee boom a particularly large set of new programs and transfers had been created, but retrenchment looked politically costly when the boom was over. Social peace was perceived as being highly dependent on the preservation of entitlements to public-sector services and income transfers. The country's political equilibrium had been built around those "rights." This not only made policy reforms difficult, but it also guaranteed that the impact of the crisis would be suffered the most by the politically least powerful segments of society.

V. The Role of Foreign Borrowing

Access to foreign financing during a balance-of-payments crisis is generally believed to be welfare improving because it permits the smoothing of consumption during a period when policy reforms can be undertaken. Underlying this belief is an implicit assumption that the feasibility of the policy reforms and the behavior of the authorities are independent of the inflow of foreign funds. The recent experience of Costa Rica suggests that--given the interactions between the political economy pressures, the behavior of the authorities, and the availability of foreign funds-- **ample access to external borrowing may not be welfare improving.**

During the early stages of the crisis the reduction in the economy's real income necessitated the adoption of expenditure-reducing policies and measures to reduce the size of the fiscal deficit, but the authorities chose to transform the fiscal deficit into a foreign debt issue by persuading foreign lenders to extend more credit, even in the absence of a consistent stabilization-cum-liberalization program. Foreign borrowing then became the cornerstone of macroeconomic policy management.

This approach was unfortunate. The decision to increase the foreign debt seriously compromised future growth for the sake of sustaining an artificial level of consumption for a few additional years. Although the foreign debt has since been renegotiated, its service has introduced balance-of-payments constraints that, even under relatively favorable predictions about the behavior of domestic savings, will inevitably result in lower rates of growth of output, as Ortiz and Serra (1983) have emphasized. Levels of debt service close to one-half of the value of exports and to 15 percent of GDP, in a country where domestic savings hardly reached 10 percent of GDP in the past, will significantly limit investment and the flow of inputs required by the highly import-intensive manufacturing and agricultural sectors.

The implied intertemporal income redistribution has been only one of the impacts of postponing the adjustment through debt. Access to foreign financing strengthened the reluctance to devalue, even when the colón had become grossly overvalued. This resulted in substantial implicit and explicit subsidies for those with access to the underpriced foreign exchange. The beneficiaries were not only those classes with a high import content in their consumption patterns, but particularly those who were able to transform a large portion of their portfolios of wealth into foreign assets. That is, public foreign borrowing and a fixed exchange rate that overvalued the domestic currency resulted in a subsidy to private capital flight for those with sufficient liquid resources to be able to speculate against the colón and for those for whom the transactions costs of foreign-asset purchases were sufficiently low.

The returns from externally borrowed resources were thereby privatized while service of the foreign debt was socialized. Indeed, in order to amortize and pay interest on this debt, the public sector has been forced to increase public-utility rates and social-security contributions while it has drastically cut back on the supply of services. Thus, while the beneficiaries of the postponement were those capable of investing abroad, the losers have been the marginal groups now deprived of public-sector services in areas such as health and education. The shares in the burden of the adjustment responded, therefore, to the political and economic strength of the distribution coalitions of interest groups.

VI. Policy Feedbacks: The Central Bank's Losses

The Carazo administration's refusal to devalue was a clear example of a generalized policy paralysis in response to the immediate political costs of action, as compared to uncertain benefits that stretched beyond its term. Policy paralysis did not mean lack of intervention, however. Rather, a multitude of *ad hoc* measures substituted for a consistent stabilization program. These interventions, moreover, created new distortions and imbalances which required new interventions. This process of responding to the unexpected consequences of earlier policy decisions with new interventions frequently led to intractable vicious circles that made macroeconomic management increasingly difficult by gradually reducing the degrees of freedom of the authorities. Thus, the decision to increase the public external debt created flows of amortization and interest that would inflate future fiscal budgets, thereby reducing the scope for discretionary spending. Similarly, the granting of foreign-exchange entitlements resulted in a flow of Central Bank losses which have become the major source of monetary expansion in Costa Rica.

In 1985, for example, the Central Bank losses amounted to CR $10,381 million (about U.S. $208 million). This amount was equivalent to 5.6 percent of GDP and to 22 percent of the value of exports. The Central Bank losses represented three-quarters of the consolidated public-sector deficit, including the Central Bank. Thus, as Loría (1986) has also noted, **the most important component of the fiscal deficit has been located, not at the Ministry of Finance, but at the Central Bank itself**.

The Central Bank losses originate mainly from differences between interest earned and interest paid and from the Central Bank's foreign-exchange operations. They reflect the feedback of earlier policy decisions, mostly related to the granting of entitlements. For example, a substantial queue of foreign-exchange requests by potential importers had accumulated in 1981 at the time when an Extended Facility Agreement was signed with the IMF. This agreement forced the Central Bank to substitute U.S. dollar-denominated, interest-earning deposit certificates for the entitlements in the queue at the prevailing exchange rate. The beneficiaries, in turn, sold these certificates at the Stock Exchange.

In general, losses from its foreign-exchange transactions resulted when the Central Bank exchanged foreign resources that it had borrowed for assets denominated in domestic currency. The Bank's own foreign debt expanded rapidly as the institution was called upon to finance the public-sector deficit and the commercial bank's credit expansion, in view of the contraction of domestic deposit mobilization. The Bank borrowed from foreign commercial banks, placed floating-rate notes abroad, and paid above-market interest rates on deposits in foreign currency. The Bank accepted the foreign-exchange risk on its own debt as well as on the debt of the state-owned commercial banks. These losses were compounded by the sales of foreign exchange to public-sector agencies at subsidized rates and by exchange-rate subsidies to the private sector for "essential" imports. The monetary impact of the revaluation in domestic currency of the external debt has so far been postponed through debt renegotiations. Nevertheless, the losses implicit in this revaluation will increase automatically through time with devaluation.

In order to sterilize the consequences of excessive domestic credit expansion, the Central Bank has undertaken open-market operations by issuing its own stabilization bonds. The high interest rates needed to compete in this market have further increased the Bank's interest expenditures. The costs of monetary stabilization have represented 25 percent of the Bank's losses. In order to reduce these losses, while at the same time keep control over the expansion of domestic credit, the Central Bank has more recently attempted to substitute other policy measures, such as increased reserve requirements and non-interest-earning prior import deposits, for these open-market operations.

These interventions have been insufficient, however, in view of the extent of the monetary disequilibrium. The sales of stabilization bonds have continued to grow. Unfortunately, while in a particular year the Central Bank may sterilize a domestic credit expansion with sales of its stabilization bonds at high interest rates (recently between 25 and 30 percent), such actions automatically increase the future growth of the monetary base in the amount of the interest payments to service those bonds. Moreover, once reserve requirements became too high --in the sense discussed by McKinnon and Mathieson (1981)-- their further use has been very limited. The Central Bank losses have, therefore, constrained the Bank in the use of two of its most important policy instruments: open-market operations and reserve requirements.

After renegotiation of the country's external debt, the Central Bank became the only borrower from the foreign banks, for all past and new debt. The Central Government, autonomous institutions, and nationalized banks, in turn, borrow from the Central Bank. When these institutions do not service their debt in time, the payments arrears become an additional mechanism for the forced financing of the fiscal deficit by the Central Bank. Thus, the effort to centralize all of the country's external debt at the Central Bank in order to control its rate of expansion and facilitate renegotiations backfired and, as a result, further constraints limit the actions of the monetary authorities. The centralization of foreign borrowing led to the loss of the Central Bank's autonomy and it transformed a foreign-debt problem into a monetary-expansion problem. The Central Bank cannot levy other taxes in order to pay for its losses; it can only collect the inflation tax through money creation.

The Central Bank also paid Costa Rican exporters for their sales to Central American countries, but it has not received payment from these nations, as reported by Brock and Meléndez in this volume. Since payment of such entitlements to exporters implied an addition to the monetary base, the Central Bank sought to sterilize it with sales of stabilization bonds, thereby further increasing its losses.

Traditionally, inflationary pressures resulted from the expansion of domestic credit in order to finance a public-sector deficit. In recent years, however, the Central Bank's losses have been a more important source of monetary expansion. This expansion of the monetary base has not been reflected in the balance sheet of the institution as an expansion of domestic credit, however, but as an expansion of net other assets which, in turn, reflects the Central Bank's losses. This expansion has reflected the extent to which monetary policy has become hostage to the financial needs of the public sector. From a position of main architect of the country's economic policies, the Central Bank has become a passive source of funds for the financing of the explicit fiscal deficit and the implicit credit and foreign-exchange subsidies. In the political economy struggle among institutions, the interests of the other agencies have prevailed over those of the monetary authority. Central Bank losses have reflected this diversion of the institution's energies toward areas not typical of a monetary authority.

In order to mitigate the inflationary consequences of the accompanying monetary expansion, the Central Bank has been forced to crowd out the private sector from bank credit portfolios. The financial system has become, therefore, less of an intermediary between private savers and investors and more of a fiscal instrument to finance the public sector.

VII. Financial Reforms

Since its creation in the 1950s, topes de cartera (ceilings on the amount of credit outstanding by bank and by economic activity) had been the main instrument of Central Bank policy in Costa Rica. With these ceilings the authorities had attempted to influence both resource allocation and the rate of expansion of domestic credit. This system had become increasingly vulnerable to political pressures as interest groups actively engaged in efforts to increase the level of the ceilings on the loans for their particular lines of activity and as inflation increased the subsidy implicit in the preferential interest rates set by the Central Bank for priority sectors.

By the end of 1978, however, the Carazo administration undertook a partial financial reform. Interest rates were raised to positive levels in real terms and became competitive with rates paid on foreign financial assets. In response to the financial reform the ratio of bank deposits to GDP increased sharply, in reflection of a high interest elasticity of financial assets. In the presence of a growing fiscal deficit, however, the shortcomings of a partial reform became evident. A reluctance to similarly raise the interest rates paid on government bonds led to a major portfolio shift from bonds to bank deposits. This further reduced the ability of the public sector to finance its deficit by placing its own paper in the market for securities. Instead, the fiscal deficit was increasingly financed with foreign and domestic bank credit. Thus, while the interest-rate reform stimulated deposit mobilization through the banking system, the private sector was crowded out of the bank credit portfolios. The explosive fiscal disequilibrium of subsequent years resulted in interest rates not adjusted sufficiently to account for the high rates of inflation and in financial repression. As a consequence, financial reform acquired a bad reputation.

Given the multiple determinants of the crisis, when Monge (1982-1986) took over from the Carazo administration the authorities faced three interrelated issues: (a) how to redefine the strategy of development in order to return to the high-growth path of the previous decades; (b) how to eliminate the fiscal disequilibrium in order to stabilize domestic prices, employment, and the exchange rate; and (c) how to distribute the costs of the adjustment across the various segments of society in order to mitigate the impact of the crisis on the weakest, to maintain internal peace in a turbulent region, and to protect Costa Rica's democratic institutions. Protection of the country's unusual social contract was viewed as essential to guarantee a climate conducive to renewed investment and growth. This multiplicity of objectives raised difficult questions about the timing, sequencing, and speed of the policy interventions.

The authorities chose to concentrate their efforts on stabilization. One cannot seriously think about structural reforms if the power needed to stabilize the economy is not there. Moreover, as Camacho and González-Vega (1985) discuss, stabilization required a decisive shock treatment in order to break up highly unstable expectations concerning inflation and exchange-rate devaluation. Stabilization required control over the public-sector deficit, a reduction in the rate of domestic credit expansion, and renegotiation the foreign debt. With fiscal and monetary discipline, the rates of inflation and of devaluation were brought under control. Stabilization also resulted from renewed capital inflows.

Substantial amounts of foreign assistance have been forthcoming and have played a major role in channeling inflationary pressures towards the balance of payments. By itself U. S. AID assistance increased from U.S. $13 million in 1981 to $212 million in 1983. In the absence of some fiscal and monetary discipline, no feasible amount of foreign financial assistance would have stabilized prices and the exchange rate. These large inflows of foreign savings may have retarded, on the other hand, the adoption of structural reforms required to guarantee the long-run sustainability of the stabilization efforts. In particular, the willingness to reduce not only the size and role of the public sector but also the degree of protectionism may have been weakened by the implicit bail out.

Since 1984 the Central Bank, under the leadership of Eduardo Lizano, has slowly undertaken another financial reform. The ceilings on the amounts of credit by activity were gradually eliminated and the banks were allowed greater independence in the setting of their interest rates. The scope of credit subsidies was specifically defined and limited. Automatic access to Central Bank credit by CODESA and other autonomous institutions was eliminated. An increasing scope was provided for the activities of the private commercial banks in competition with the state-owned banks. The Central Bank attempted to regulate monetary expansion with reserve requirements and open market operations, as explained by Lizano (1987). Despite its success in containing the losses of the Central Bank and in changing the behavior of the state-owned banks towards a more market-oriented attitude, this partial deregulation also resulted in a very large increase in commercial and personal credit, that was stimulated by tariff reductions and a larger car import quota, and in reductions in loans to productive sectors, particularly agriculture, which had to be disbursed at a subsidized interest rate. The banks also soon learned to bypass reserve requirements with creative innovations so that domestic credit --and, as a result, imports-- increased more than had been expected. These unexpected adverse consequences fueled opposition to the reforms.

Lizano's strategy had been to introduce the reforms gradually and slowly in order to minimize political opposition. Gradualism, however, allowed time for those hurt by the elimination of the subsidies to combine and exert increasing pressure for the reversal of the policy reforms. Opposition came, in particular, from the agricultural sector, which had recently enjoyed substantial price, credit, insurance, and other subsidies. As Mesalles (1988) discusses, the situation became politically sensitive when droughts and a reductions in the international price of several export crops created a crisis in the agricultural sector. Legislation was approved in Congress to reschedule most delinquent agricultural loans at subsidized interest rates. For 1988, the Central Bank set a limit of five percent on credit expansion by bank and a portfolio limit of 30 percent on personal, commercial, and service-sector loans. The Executive branch, in turn, imposed specific credit limits, by activities, on the state-owned banks, bypassing the Central Bank. Strong political economy pressures may lead to a reversal of the most appropriate liberalization attempts of Governor Lizano.

Notes

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